
◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

THIRD QUARTER 2002

Regional Perspectives

FDIC NEW YORK REGION



◆ *The Region's Largest Metropolitan Areas Have Weathered This Recession Differently*—This article analyzes the timing and severity of job losses among the Region's larger metropolitan statistical areas (MSAs) during the recent economic downturn and compares economic performance with that of previous recessions. Characteristics of the 2001 recession and economic profiles of the major MSAs help explain differences in local employment trends, banking performance, and prospects for economic recovery. *See page 3.*

◆ *Profitability Rebounds among the Region's Large Banks; However, Challenges Remain*—After declining in the second half of 2001, profitability among the Region's large banks rebounded in first quarter 2002. Moderate increases in net interest margins and in noninterest income (primarily in consumer lines of business) and stabilization of loan loss provisions contributed to higher earnings among large banks. However, loan delinquency and charge-off rates remained elevated, a situation that could require additional loan loss reserves. *See page 8.*

By the New York Region Staff

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In Focus This Quarter

◆ *The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead*—The recession that began in March 2001 has been especially hard on the corporate sector. Banks that made loans to affected firms felt the immediate effects of the recession through rising problem commercial loans. Large banks took the brunt of this commercial credit deterioration, as indicated by a somewhat larger uptick in problem commercial loans among large banks compared with smaller banks. This credit deterioration was more apparent at banks that participated in loan syndications, one of the financing vehicles available primarily to large corporate customers. Various indicators pointing toward economic recovery, as well as an apparent decline in rating downgrades and default rates among corporate bond issuers in recent weeks, suggest that improvement in commercial credit quality may be just ahead. This recovery, however, faces a few hurdles, including continued high leverage, weak earnings, and prospects for a more difficult funding environment, particularly for speculative-grade corporations with maturing debt. *See page 10.*

By Cecilia Lee Barry, Senior Financial Analyst

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Regional Perspectives

- An examination of the economic profiles of the Region's larger metropolitan areas can help explain the timing and severity of economic weakness during this recession, differences in how certain groups of banks have performed, and prospects for economic recovery.
- Earnings reported by the Region's large banks benefited from wider margins and lower loan loss provisions in first quarter 2002. However, loan delinquency levels remain elevated, and costs associated with problem loans could increase in coming quarters.³

Introduction

A political axiom states, "Where you stand depends on where you sit." Similarly, your view of the economy may depend largely on the location of your window. The Region's largest metropolitan statistical areas (MSAs) weathered the recent recession differently—a reflection of the disparate economic and industrial makeup of these areas. These differences may offer clues to the pace of their recovery as well. This article analyzes the timing and severity of job losses among the Region's larger metropolitan areas during the recent economic downturn and compares economic performance with that of previous recessions.¹ For purposes of this analysis, the Region's metropolitan areas are categorized into three groups: MSAs that experienced job losses early in this business cycle (Early Losses), MSAs whose economies were more directly affected by the events of September 11 (September Effect), and MSAs that experienced minimal or no job losses (Sporadic Losses).² The characteristics of the 2001 recession and the economic profiles of these groups of MSAs help explain differences in employment trends, banking performance, and prospects for economic recovery.³

How Does This Recession Compare with Past Recessions?

The recent recession displayed some characteristics of the 1981–1982 and 1990–1991 recessions but avoided others. Similar to the economic downturn of the early 1980s, the roots of the 2001 recession took hold in the nation's manufacturing sector. In the most recent recession, however, weakness then spread to the information technology (IT) sector, as excesses in the IT industry became apparent. Subsequently, the IT bubble burst, and the effects spilled over to the stock market and contributed to declines on Wall Street, including equity financing, brokerage, and merger and acquisition (M&A) activity. The Federal Reserve Board's shift to an expansionary monetary policy and the federal government's fiscal stimuli helped offset the nation's overall economic weakness. However, the events of September 11 were particularly detrimental to the Region's securities and investment banking industries, which were already weakened, as they were in the recession of the early 1990s. In addition, business and consumer confidence declined and fallout spread to the travel, tourism, and transportation industries nationwide. Fortunately, the recent recession has not been characterized by significant consumer retrenchment, and the woes of the financial sector did not include weakness in the Region's residential real estate, commercial real estate, and banking sectors—unlike the 1990–1991 downturn. In contrast to the early 1990s recession, when housing prices declined sharply, prices in most of the Region's metropolitan areas have remained stable or risen during this recession. Moreover, unlike the early 1990s, when the Region's commercial real estate markets were characterized by significant excess supply of new construction, today's rising office vacancy rates across many of the Region's metropolitan areas generally reflect declining demand for space.⁴

¹ Analysis was limited to the Region's metropolitan areas that have a labor force of at least 200,000 and at least six insured institutions with total assets less than \$10 billion, excluding credit card banks. Twenty-one of the Region's 45 MSAs met these criteria as of March 31, 2002. A list of the MSAs included in this analysis appears in the appendix table.

² Employment data through May 2002.

³ For purposes of this analysis, the business cycle trough is assumed to be December 2001. See DRI-WEFA chief economist's presentation entitled "Are We Headed for a Jobless and Profitless Recovery?" in New York City on May 28, 2002.

⁴ For more information on how this economic downturn compares with past recessions, see *Regional Outlook*, "In Focus This Quarter," Second Quarter 2002.

The financial condition of insured institutions also differs from a decade ago. The Region's insured institutions are generally better capitalized and report more favorable credit quality than during the early 1990s.⁵ During the current economic downturn, credit quality weakness has been largely concentrated in commercial and industrial (C&I) loan portfolios, as C&I delinquency rates increased notably during the recent recession, particularly for the Region's large banks (see box on page 8). Excluding subprime consumer loans, increases in consumer loan delinquency rates among the Region's insured institutions have been relatively modest, reflecting generally favorable conditions in the consumer sector. Consumers and their quest for home ownership, supported by low interest rates, helped buffer the effects of this economic downturn on the Region's (and the nation's) economy. Nonetheless, as the timing and severity of job losses varied for the three groups of MSAs identified in this analysis, so did the degree of credit quality weakening for the Region's insured institutions (see Charts 1 and 2).

Job Losses Started Earlier in the Region's Manufacturing Areas

Consistent with trends nationwide, the Region's metropolitan areas that lost jobs early in this downturn

(Early Losses) generally have a high concentration of manufacturing employment. The MSAs in this group include **Buffalo-Niagara Falls, Rochester, and Syracuse, NY; Bergen-Passaic and Newark, NJ; and Scranton-Wilkes-Barre, PA.** The average concentration in manufacturing jobs was 16 percent for these MSAs, compared with 13.8 percent for the nation as of first quarter 2001.

Rochester is representative of the Region's metropolitan areas that experienced employment declines early in the downturn. With over 20 percent of its employment base in manufacturing, Rochester began losing jobs in April 2001, shortly after the official start of the recession. Job losses in the area's durable goods manufacturing sector outpaced job growth in some other industry sectors, such as the finance, insurance, and real estate (FIRE) sector. In fact, durable goods manufacturing losses equaled 108 percent of the area's total job losses on average from second quarter 2001 to first quarter 2002; that is, they exceeded the job additions in the city's other business sectors. Employment in the industrial machinery and equipment and electronics industries has contracted most over the course of this recession. This is not surprising, as Rochester is home to the operations of several large firms that have struggled with weakness in the IT/telecommunications sector, including Global Crossing, Kodak, and Xerox. Rochester also has a

CHART 1

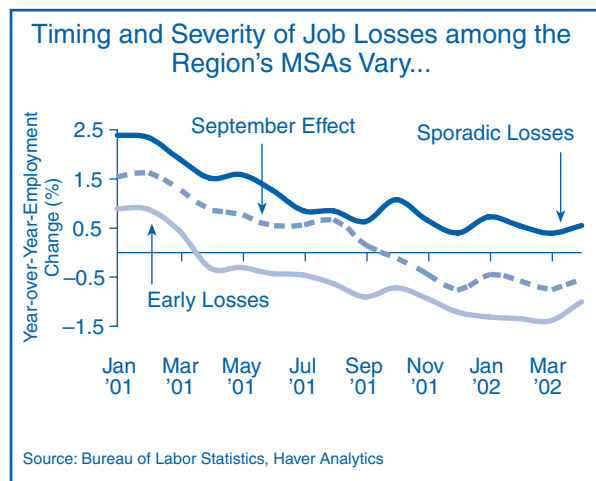
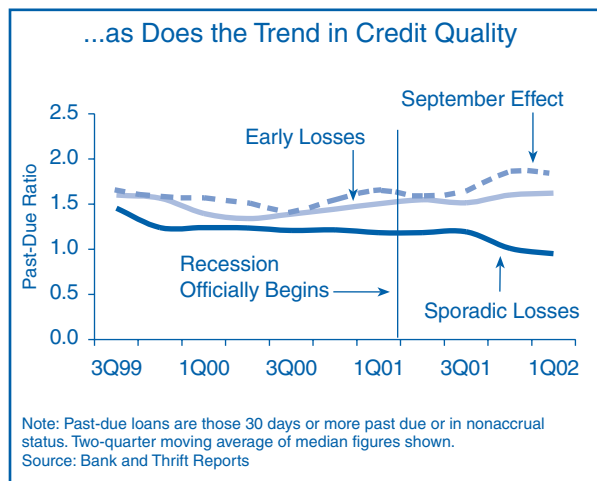


CHART 2



⁵ Unless otherwise noted, the analysis excludes institutions in operation less than three years, institutions with total assets greater than \$10 billion, and credit card banks. These three groups of institutions were excluded either because their operations have been in existence for too short a time to yield useful analysis or because their operations extend much beyond the metropolitan areas in which they are headquartered. The analysis uses median figures unless otherwise noted.

relatively high exposure to the auto industry through its auto parts and supply firms. The auto parts and supply industry is rationalizing worldwide, which has contributed to contraction in Rochester's job market.

Buffalo and Bergen-Passaic also experienced job declines in the manufacturing sector early in this downturn. It is interesting to note that the percentage of job losses in Buffalo and Bergen-Passaic has been far less than the employment declines these areas experienced during the 1990–1991 recession. Bergen's worst month during the last recession, in terms of year-over-year percentage job decline, was March 1991, when the area shed over 6 percent of its jobs. The worst month associated with the 2001 recession to date was September 2001, when the Bergen job market contracted by 1.4 percent. Employment contraction in Buffalo during the last recession was greatest in September 1991 (–3.4%) compared with April 2001 (–1.6%) during this downturn.

Consistent with the economic downturn and job declines, credit quality weakened for insured institutions in the Rochester and Buffalo MSAs to a greater extent than in the Region and the nation. The past-due ratio⁶ for insured institutions in these two MSAs began to increase in first quarter 2000 and reached 2.17 percent in first quarter 2002, which exceeded the regional and national averages.⁷ Moreover, despite weakening economic conditions locally, insured institutions in the Rochester and Buffalo MSAs have reported an increase in the average concentration of traditionally higher-risk loan types—that is, C&I and commercial real estate (CRE). During the past two years, the average concentration in C&I and CRE loans for insured institutions in the Rochester and Buffalo MSAs increased from 24 percent to 35 percent, rising from below the regional average to slightly above average.⁸

Insured institutions in the Bergen-Passaic MSA also reported an increase in the average concentration of C&I and CRE loans to assets over the past two years. However, in contrast to the Rochester and Buffalo MSAs, the average past-due ratio for insured institutions

in the Bergen-Passaic MSA has been relatively stable during this recession and has remained lower than the regional and national averages. However, credit quality is typically a lagging indicator and thus may weaken further as the effects of the downturn filter through insured institutions, particularly if the recovery is slow.

New York City's Early Job Losses Were Not Due to Manufacturing Weakness

Like the Region's other MSAs that experienced job declines early in the downturn, **New York City** had job losses during the first part of the recession. However, the preponderance of job losses occurred in the FIRE and services sectors, not in manufacturing. These sectors began weakening in early 2001 and worsened gradually until September 11. After September 11, New York City ranked among the top ten MSAs in the nation in terms of percentage of job losses, as businesses quickly shed jobs in reaction to the drastic slowdown in the area's tourism, business services, retail, and FIRE industries, among others.

Despite early entrance into this recession and relatively high job losses, credit quality among insured institutions in the New York City metropolitan area remained favorable through first quarter 2002. The average past-due ratio increased moderately in the second half of 2001, consistent with economic weakening, but declined in first quarter 2002 and, at 1.36 percent, remained below regional and national averages. Additionally, while softening in CRE markets has accompanied moderately increasing CRE loan delinquency rates for the area's banks, the average past-due ratio for CRE loans remains below the regional average. Nonetheless, insured institutions in the New York City MSA, which hold one-quarter of their portfolios in CRE loans, have reported an increase in the average CRE loan past-due ratio over the past year, from .27 percent to .65 percent. Office vacancy rates in New York City increased through second quarter 2002 but remained below the national average. Continued softness in office market conditions could lead to further weakening in CRE loan quality among the area's banks.

Some of the Region's Metropolitan Areas Have Lost Few, if Any, Jobs

Eight of the Region's MSAs were not pulled into recession by the manufacturing sector decline or the effects of September 11. These MSAs experienced minimal or

⁶ Past-due loans are defined as loans more than 30 days past due or loans in nonaccrual status.

⁷ The regional and national averages for the percentage of loans past due as of first quarter 2002 are 1.58 percent and 1.97 percent, respectively.

⁸ The average concentration of commercial loans to total loans for the Region's banks increased from 28 percent to 34 percent over the same period.

no job losses (Sporadic Losses) between March 2001 and May 2002. The primary commonality among these MSAs is the relatively high growth in government and service sector jobs, particularly in the health care sector. The concentration of jobs in these sectors has insulated many MSAs in this group from the significant contraction experienced by other industry sectors. Government employment tends to be acyclical; that is, demand is not driven by the business cycle. During the year ended first quarter 2002, the government and health services sectors contributed 16,700 and 11,400 jobs, respectively, to the eight metro areas in the Region that have experienced only minimal or sporadic job losses. These 28,100 jobs represented almost 0.5 percent of the aggregate labor force of these MSAs, approximately equal to the percentage job growth reported by these areas during the year. In first quarter 2002, job growth among these MSAs compared favorably to the nation, which experienced negative job growth of 1.24 percent.

It is not surprising that federal, state, and local governments have continued or expanded hiring, especially in the wake of September 11. Heightened security concerns have increased demand for military, intelligence, and federal law enforcement officials, as well as for police officers, firefighters, and game wardens to monitor and protect public watershed areas and other public sites. In the service sector, the health services industry has contributed the most to employment growth. Health services also tend to be acyclical, and demand for health care will continue to increase as the baby boom generation ages.

The **Nassau-Suffolk** and **Washington, DC**, MSAs are examples of areas in the Region that experienced few, if any, job losses through May 2002. In Nassau-Suffolk the gains in health care and government almost offset employment losses in the area's manufacturing and FIRE sectors. In Washington, DC, job increases in these industries did make up for losses in the area's other major industry sectors. In central New Jersey (**Middlesex** and **Trenton** MSAs), strong gains in government and health services were augmented by notable gains in retail trade, together adding enough jobs to offset the continued losses in the manufacturing, transportation, and public utilities sectors.

In addition to experiencing healthier employment growth, many of these metropolitan areas are among the wealthiest in the Region, based on home price appreciation and personal income growth. Home price appreciation in these MSAs averaged 9.2 percent in the year ended first quarter 2002, compared with a 6.2

percent average increase across the Region and 5 percent for the nation (excluding the Region).⁹ Average personal income in these MSAs increased 7.6 percent between 1999 and 2000 (the most recent period available) but grew by only 6.7 percent for the Region as a whole.¹⁰

Not surprisingly, credit quality reported by insured institutions headquartered in these MSAs has been more favorable during this economic downturn than that of institutions in MSAs that experienced more significant employment declines (see Chart 2, page 4). However, while the median loan delinquency ratio was lower through first quarter 2002, the median concentration of typically higher-risk loan types, particularly CRE loans, was higher than for institutions in the Region's MSAs that experienced significant declines in employment.¹¹ Should economic conditions in areas that have experienced little, if any, employment decline materially change, these insured institutions could experience some weakening in commercial credit quality.

Indicative of the stronger economic performance, new bank formation during this economic cycle has been most active in the MSAs that experienced sporadic job decline. New bank formation, most notably in New Jersey's metropolitan areas, reflects, in part, strong economic conditions and industry consolidation in the late 1990s. Consequently, before 2001, 28 percent of institutions in this group of MSAs had not previously been tested by an economic recession, compared with 16 percent for the Region overall.¹² In addition, more than half of the untested institutions in these areas are commercial lenders¹³—that is, active in traditionally higher-risk, higher-yielding loan categories. Should overall economic recovery develop slowly, institutions previously untested by an economic recession, particularly those with high levels of traditionally riskier loans, could be more vulnerable to credit quality deterioration.

⁹ Office of Federal Housing Enterprise Oversight.

¹⁰ Bureau of Economic Analysis.

¹¹ The average concentration of loan portfolios in C&I and CRE loans for insured institutions in the Sporadic Losses group of MSAs is 46 percent, compared with 41 percent for the Early Losses group and 27 percent for the September Effect group.

¹² Institutions that had not been tested by an economic recession before 2001 were established after December 31, 1991.

¹³ Commercial lenders hold more than 25 percent of assets in C&I and CRE loans.

The Events of September 11 Pulled Several of the Region's Major MSAs into Recession

Six of the Region's 21 major MSAs did not experience employment losses until after September 11. These areas arguably were pulled into recession by the economic fallout from September 11 (September Effect). Unlike the Early Losses and Sporadic Losses groups, no one characteristic binds this group of metropolitan areas. Three MSAs are relatively large (**Philadelphia, Baltimore, and Pittsburgh**), while the others are smaller (**Harrisburg, Wilmington, and Allentown**). These areas gained jobs in health services but lost jobs in manufacturing. Insured institutions headquartered in this group of MSAs reported a lower average concentration in typically higher-risk loan types compared with the other MSA groups. However, these institutions reported an increase in past-due loan ratios at the end of 2001, consistent with the acceleration of economic decline following September 11.

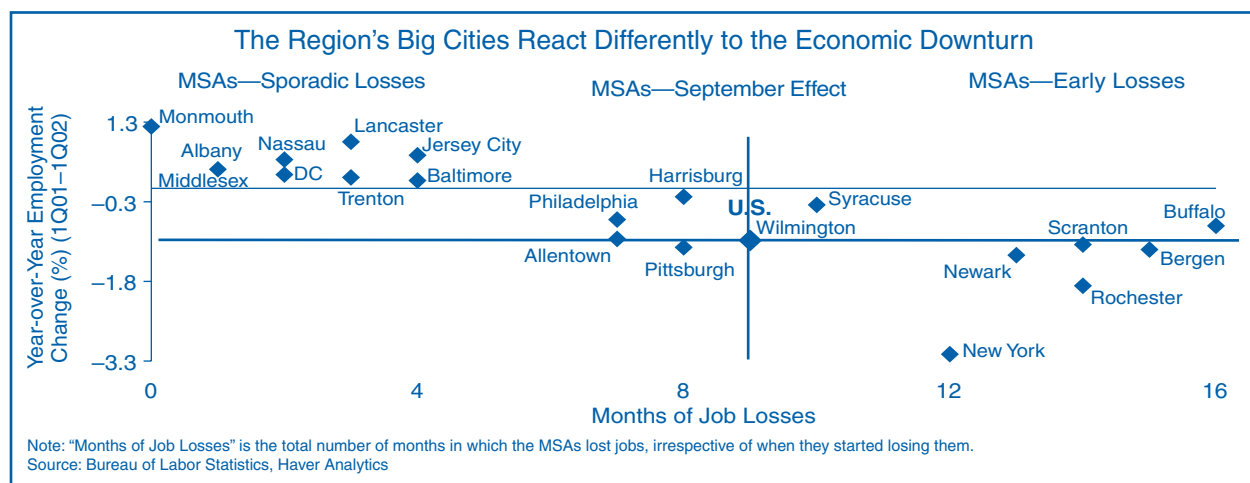
Pace of Recovery among the Region's Metropolitan Areas Will Differ

The economic profiles of the Region's major metropolitan areas affected their performance before and during the 2001 recession and will continue to do so during the recovery. The MSAs that began losing jobs early in this recession (except New York City) will be heavily influ-

enced by trends in the manufacturing sector. Analysis of the *Institute for Supply Management's* (ISM) manufacturing index shows a lag of 6 to 12 months at the national level between the manufacturing index and the employment index.¹⁴ The lag tends to increase when the economy is on the upswing, because employers hesitate to add workers until they are confident that the recovery "has legs." The overall manufacturing index turned positive in February 2002. As a result, employment growth may be months away. New York City's recovery will be linked to conditions in its financial services sector.

Metropolitan areas that suffered job declines as a result of September 11 are likely to begin showing signs of strength roughly on a par with the rest of the nation. The relatively high level of industrial diversity (i.e., a diversified employment base across industry sectors) of these MSAs has benefited them. In fact, as a group, these six MSAs have a higher average industrial diversity than the other MSAs analyzed for this article. While this group does not benefit from high concentrations in government and health services, neither does it have high concentrations in manufacturing. As Chart 3 indicates, employment growth for this group has approximated the national average during this economic downturn. Average employment changes in this group correlate at a 98.3 percent rate with the United States as a whole, which is higher than each of the other two MSA groups, reinforcing the expectation that the economic recovery of this group will track that of the nation.

CHART 3



¹⁴ The ISM manufacturing index measures the overall health of the nation's manufacturing index and comprises several components, including new orders, shipments, and employment. As of July 2002, the index showed expansion in the sector for six consecutive months.

The recovery apparently is further along in the group of MSAs that has experienced few, if any, job losses—those with comparatively higher concentrations in the government and service sectors. However, it likely will take time for any economic recovery to be reflected in

insured institution credit quality. In fact, as credit quality typically lags economic conditions, certain insured institutions in the Region may continue to experience deterioration in segments of the loan portfolio as the economy recovers.

Profitability Rebounds among the Region's Large Banks; However, Challenges Remain

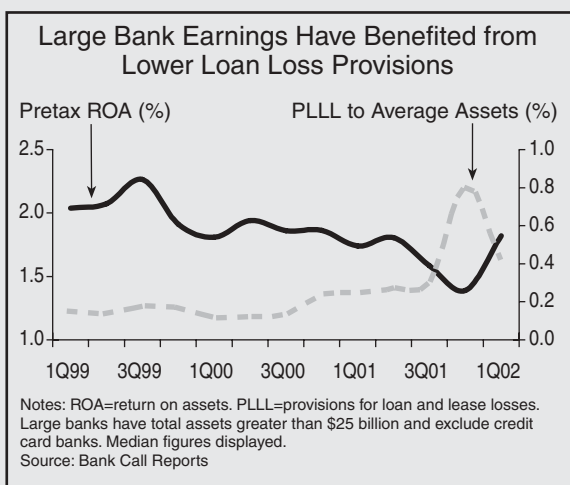
After declining in the second half of 2001, profitability among the Region's large banks,¹⁵ as measured by pretax return-on-assets (ROA), increased in first quarter 2002. Most of the Region's large banks reported stable or moderately increasing net interest margins (NIMs) in first quarter 2002 compared with the previous quarter. Several of these institutions reported declining asset yields but also lower funding costs following the decline in short-term market interest rates in late 2001. Large banks' average cost of funds, which is highly sensitive to changes in short-term interest rates, reached the lowest recorded level at approximately 2 percent in first quarter 2002.¹⁶ Funding costs are likely to level off, as short-term interest rates began to stabilize in early 2002.

Profitability also was aided by a moderate increase in non-interest income, although certain business lines did better than others. Revenues that are sensitive to equity markets (such as investment banking and venture capital revenues)

declined, while low interest rates helped fixed-income underwriting and trading business lines, as well as revenue from loan sales and servicing. Additionally, consumer lines of business benefited from increased income from service charges and other deposit account fees.

Profitability among the Region's large banks also increased because problem loan costs abated in first quarter 2002. Provisions for loan losses leveled off following a sharp increase at the end of 2001, as several large banks took charges in response to economic conditions in Argentina, Enron and other corporate bankruptcies, and exposure to the troubled telecommunications industry. Profitability for some of the Region's large banks trails levels of a year ago; however, average provision expense moderated in first quarter 2002, helping the average ROA to rebound (see Chart 4). Nonetheless, loan delinquency¹⁷ and charge-off rates remained elevated in first quarter 2002 (see Chart 5), a situation that could require additions to loan loss reserves. Furthermore, credit quality improvement typically lags economic recovery, and, as a result, higher levels of problem loan costs could continue as the economy rebounds and troubled industry sectors restructure.

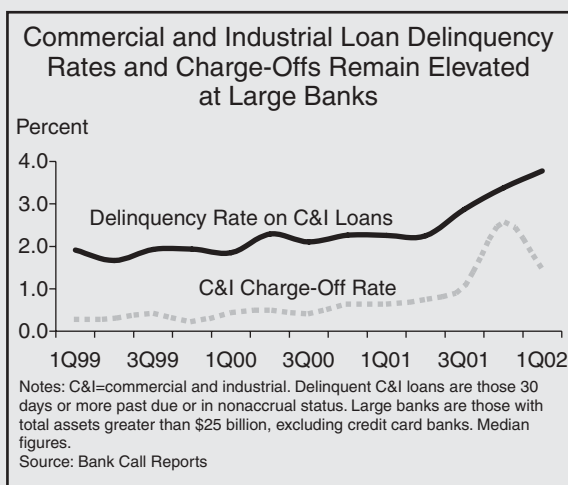
CHART 4



¹⁵ Large banks are defined as institutions with total assets greater than \$25 billion, excluding credit card banks. Median figures are used unless otherwise noted.

¹⁶ Data available since first quarter 1984.

CHART 5



¹⁷ Loans 30 days or more past due or in nonaccrual status.

APPENDIX TABLE 1

THE TIMING OF JOB LOSSES AMONG THE REGION'S MSAS VARIED DURING THIS RECESSION; HISTORY SUGGESTS THAT JOB LOSSES MAY CONTINUE AFTER RECESSION OFFICIALLY ENDS			
MSA	TOTAL MONTHS OF JOB LOSSES DURING THIS RECESSION	FIRST MONTH OF NEGATIVE JOB GROWTH IN THIS RECESSION	AVERAGE SHARE OF JOB LOSSES AFTER OFFICIAL END OF PRIOR RECESSIONS ⁽¹⁾ (%)
EARLY JOB LOSSES			
BUFFALO-NIAGARA FALLS NY	16	JAN-01	62.60
BERGEN-PASSAIC NJ PMSA	15	MAR-01	52.17
SCRANTON—WILKES-BARRE—HAZELTON PA	14	APR-01	52.30
ROCHESTER NY	14	APR-01	70.45
NEWARK NJ PMSA	13	MAY-01	58.27
NEW YORK NY PMSA	12	JUN-01	35.12
SYRACUSE NY	10	APR-01	54.15
JOB LOSSES POST-SEPTEMBER 11			
WILMINGTON-NEWARK DE-MD PMSA	9	SEP-01	60.48
HARRISBURG-LEBANON-CARLISLE PA	8	OCT-01	62.04
PITTSBURGH PA	8	OCT-01	68.96
PHILADELPHIA PA-NJ PMSA	7	Nov-01	52.74
ALLENTOWN-BETHLEHEM-EASTON PA-NJ	7	Nov-01	70.84
BALTIMORE MD PMSA	4	Nov-01	52.31
SPORADIC JOB LOSSES			
LANCASTER PA	3	JUL-01	55.32
JERSEY CITY NJ PMSA	4	JUL-01	52.53
NASSAU-SUFFOLK NY PMSA	2	APR-01	54.55
TRENTON NJ PMSA	3	MAR-02	49.92
WASHINGTON DC-MD-VA-WV PMSA	2	Nov-01	36.96
ALBANY-SCHENECTADY-TROY NY	1	Nov-01	60.44
MIDDLESEX-SOMERSET-HUNTERDON NJ PMSA	1	MAY-02	59.09
MONMOUTH-OCEAN NJ PMSA	0	N/A	25.00
(1) INCLUDES NATIONAL RECESSIONS DURING 1980, 1981-82, AND 1990-91. PMSA = PRIMARY METROPOLITAN STATISTICAL AREA SOURCE: BUREAU OF LABOR STATISTICS			

New York Region Staff

The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead

Introduction

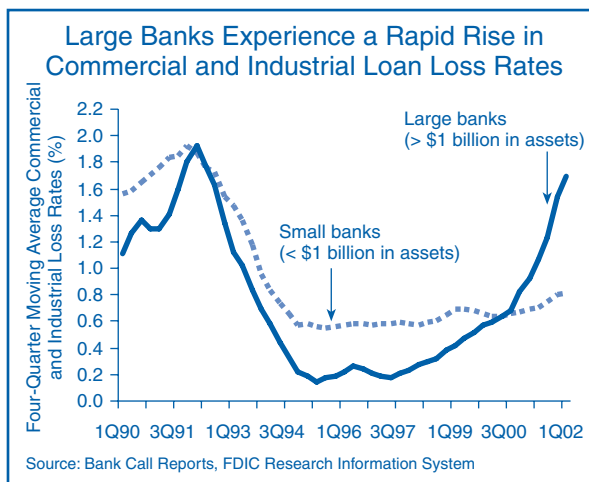
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic indicators pointing toward recovery, the volume of problem commercial loans held by insured institutions could plateau during 2002. Many banks tightened business loan underwriting standards beginning in early 2000, a trend that should contribute to an eventual turnaround in commercial loan quality. Nevertheless, several factors could delay this improvement. Corporate profitability has yet to recover fully, and many firms continue to operate with significant financial leverage. Highly leveraged firms are especially vulnerable to declining revenues, which reduce the cash flow available to service debt obligations. More significantly, lower investor tolerance for risk has created a far less hospitable financing market for speculative-grade firms, possibly straining liquidity and increasing the likelihood that these companies could default as debts mature.

Commercial Credit Deterioration Should Subside with the Economic Recovery

While the banking industry has fared well through the latest recession, it did not escape the effects of the troubled corporate sector. Large banks (those with assets greater than \$1 billion), in particular, have seen a significant rise in noncurrent commercial and industrial (C&I) loan and loss rates.¹ While total C&I loans represented 25 percent of all outstanding loans held by all insured commercial banks as of March 31, 2002, net C&I loan losses comprised 32 percent of all loan losses. In first quarter 2002, noncurrent C&I loans reached 2.6 percent of outstanding loans (2.8 percent for large banks), the highest level since fourth quarter 1993. The four-quarter moving average C&I loss rate also rose among small and large banks; however, the rate of increase for large banks was significantly higher, as shown in Chart 1.

¹ Noncurrent loans are defined as loans 90 or more days past due or on nonaccrual status.

CHART 1



Improving economic conditions and tighter underwriting standards suggest that commercial credit quality should improve. A range of indicators suggests that economic recovery is under way, albeit more slowly than some expected earlier this year. The housing sector remains robust, job conditions have stabilized, and real gross domestic product (GDP) grew 5.0 percent in first quarter 2002. Although GDP grew at a slower pace of 1.1 percent in second quarter 2002, business equipment spending increased 2.9 percent, in contrast to a decrease of 2.7 percent in first quarter 2002. Also, the manufacturing sector began to show signs of recovery with the *Institute for Supply Management* (ISM) index for manufacturing reaching 56.2 and 50.5 in June and July 2002, respectively. The ISM index has remained above 50, which signals an economic expansion, for the six consecutive months since February 2002. Also, the index of coincident indicators, a gauge of current economic activity, rose 0.3 percent in June 2002. Furthermore, a survey of 50 leading corporate economists by *Blue Chip Economic Indicators* shows that analysts expect the U.S. economy to grow at a rate of 3.3 percent in third quarter 2002.²

Recent changes in underwriting standards also bode well for credit quality at commercial banks. The Federal

² *Blue Chip Economic Indicators*, July 2002. Also see *Regional Outlook*, Second Quarter 2002, "Back to the Future: How This Downturn Compares to Past Recessions." See <http://www.fdic.gov/bank/analytical/regional/ro20022q/na/index.html>.

Reserve Board's *Senior Loan Officer Opinion Survey on Bank Lending Practices*, which focuses on changes in the supply of and demand for bank loans to businesses and households over the previous three months, has shown consistent tightening of business loan standards during the past two years. The April 2002 survey indicated some further tightening of standards, but the percentage of banks reporting this tightening has declined since the January survey, consistent with the anticipation of a continued economic rebound.³ Since credit quality typically lags the business cycle, near-term recovery appears more likely, provided the economy continues to improve. This recovery in commercial credit quality, however, is not without a few hurdles ahead.

High Default Rates, Rating Downgrades, and Bankruptcies Persist

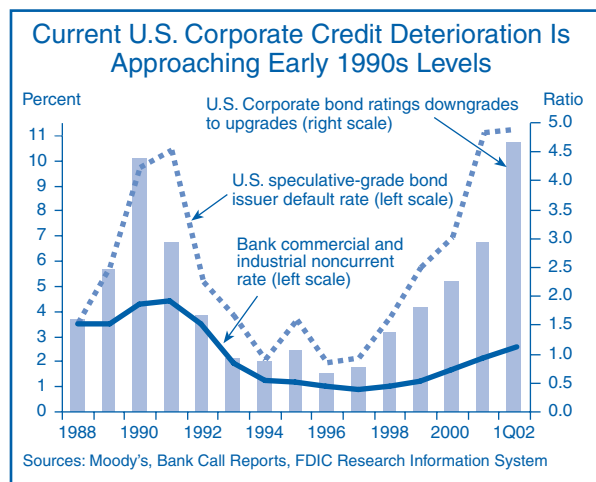
While the U.S. economy is showing signs of recovery and underwriting standards have tightened, corporate credit quality could continue to be affected by several adverse trends. The number of bankruptcies filed by public companies this year is on pace to challenge the record set in 2001.⁴ Furthermore, default rates for

U.S. speculative-grade corporate bond issuers remained high at 10.3 percent in June 2002, and the high ratio of corporate rating downgrades to upgrades indicates continuing weakness in the corporate sector (see Chart 2).⁵ The main reasons for rating downgrades have been poor profitability and high leverage.

Corporate Profitability Remains Fragile

Corporate profitability has been depressed since first quarter 2001 (see Chart 3). However, this trend is improving slowly in 2002. U.S. corporate profits rose during second quarter 2002 for the first time in five quarters.⁶ However, the rate of recovery is not expected to be strong in 2002, as some 93 companies in the Standard & Poor's 500 have announced that third quarter earnings will be less than expected, more than twice the number of companies that have announced they will beat estimates.⁷ In fact, earnings forecasts have been revised downward consistently for the past several months, and analysts have warned recently that earnings estimates for the second half of 2002 are likely to be reduced. The bright spot in earnings continues to be the consumer sector, with automobile manufacturers and certain retail areas posting strong sales. The worst-performing sectors on a

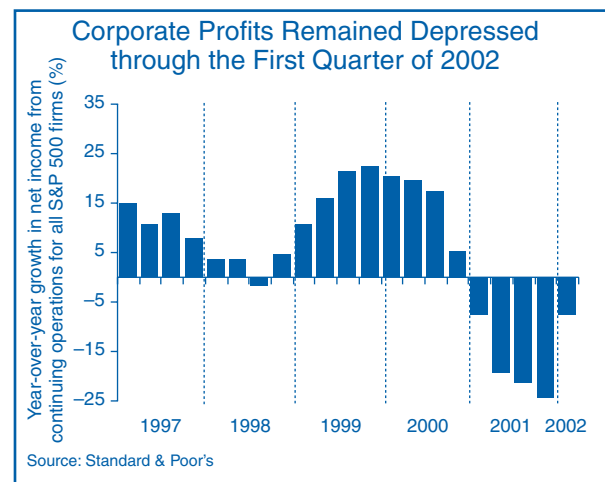
CHART 2



³ *Senior Loan Officer Opinion Survey on Bank Lending Practices*, The Federal Reserve Board, April 2002. The survey reported that the percentage of domestic banks that reported tightened standards on C&I loans to large and middle-market firms (annual sales of at least \$50 million) since the January survey declined to 25 percent from 45 percent. The percentage of domestic banks that report tightened standards on business loans to small firms declined more, from 42 percent in January to 15 percent in April.

⁴ *Bankruptcydata.com* reports that 257 publicly traded companies filed for bankruptcy in 2001, while 114 companies had filed by June 30, 2002.

CHART 3



⁵ In the first half of 2002, Moody's downgraded 262 companies and upgraded 59, producing a downgrades to upgrades ratio of 4.4:1.

⁶ On a year-over-year basis, 371 companies in the Standard & Poor's 500 Index that reported earnings through July 26, 2002, posted profits.

⁷ Danielle Sessa, "U.S. Stocks Slide as Johnson & Johnson, Pepsi Shares Tumble," *Bloomberg.com*, July 19, 2002.

year-over-year basis appear to be energy, transportation, utilities, capital goods, and communications services.⁸ The latest recession was driven primarily by the sharp decline in the demand for capital goods. With the slow economic recovery, businesses have continued to limit capital spending. The rate of recovery for corporate profitability will depend in large part on how soon and to what extent businesses resume spending.

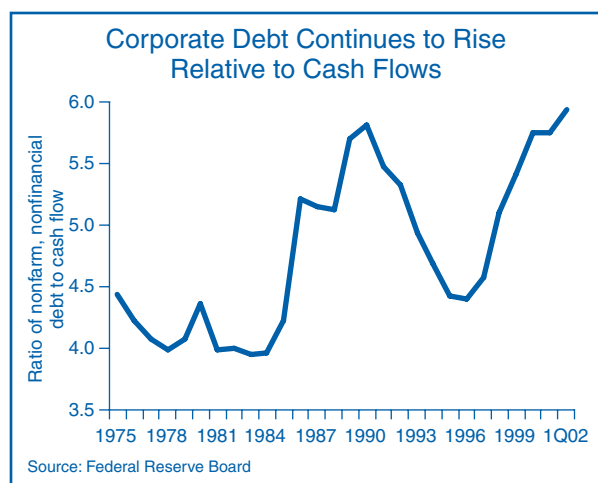
The prospect of slow earnings growth could be particularly problematic for many highly leveraged corporations. Debt levels relative to cash flow have been rising because of anemic earnings (see Chart 4). Negative earnings news also comes at a time when several well-publicized accounting irregularities have shaken investors' confidence in corporate earnings reports. A **Huron Consulting Group** study of financial restatements indicates that during the past five calendar years, the number of restated financial statements filed by public companies has grown from approximately 120 in 1997 to 270 in 2001.⁹ The number of restatements continued to grow in 2001, despite a reduction in the number of public companies. That study found that

the largest source of restatements relates to how companies recognize revenue. With depressed corporate profits and diminishing investor confidence, some firms with debts maturing in the near term may have difficulty refinancing.

Firms with Maturing Debts Could Face a Critical Period in the Near Term

Moody's estimates that \$141 billion worth of U.S. speculative-grade corporate bonds and rated bank debt will come due over the next three years: \$27 billion (19 percent) in 2002, \$54 billion (38 percent) in 2003, and \$60 billion (43 percent) in 2004.¹⁰ To put these numbers into perspective, total U.S. corporate bond defaults were \$115 billion in all of 2001, of which 95 percent of those defaulting were speculative-grade borrowers. Although Moody's expects the bulk of high-yield debt maturing in 2002 to be refinanced despite unfavorable market conditions, concern exists about the large percentage of issues rated B1 or lower that will come due in 2003 and 2004 (see Chart 5).¹¹

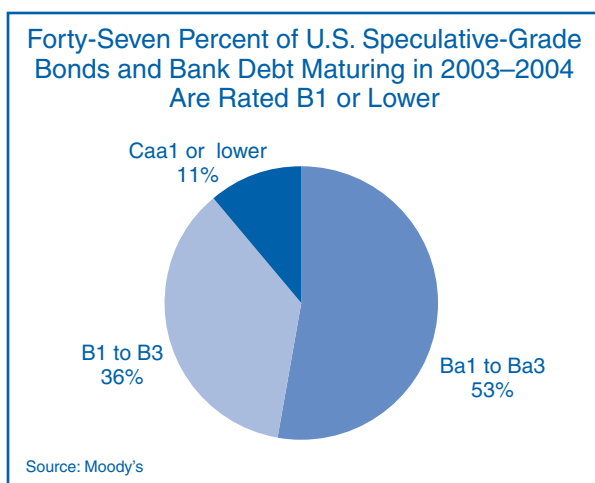
CHART 4



⁸ Charles L. Hill, et al., *This Week in Earnings*, Thomson First Call, July 22, 2002.

⁹ *A Study of Restatement Matters, for the five years ended December 31, 2001*, Huron Consulting Group, June 2002. This study excluded restatements caused by changes in accounting principles and nonfinancial-related restatements.

CHART 5



¹⁰ Tom Marshella, et al., "Refunding Risk for U.S. Speculative Grade Borrowers, 2002–2004," *Global Credit Research*, Moody's Investors Service, December 2001. Figures related to refunding risk presented throughout this article are taken from Moody's refunding risk studies, conducted annually since November 1998.

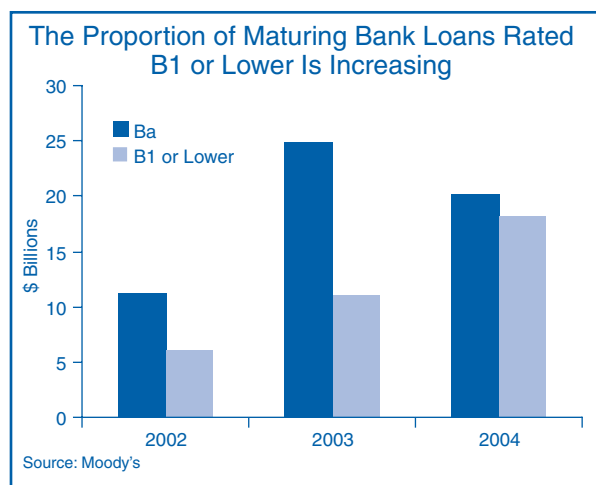
¹¹ Speculative-grade debt ratings assigned by Moody's in the order of declining credit quality are as follows: Ba, B, Caa, Ca, and C. Moody's also applies numerical modifiers 1, 2, and 3 in each generic rating classification. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category, while the modifier 3 indicates a ranking in the lower end of that generic rating category.

Credit deterioration of bank loans is similar to the current trend in corporate bonds. Migration of maturing loans into lower grade categories has accelerated in recent years (see Chart 6). This ratings decay reflects the borrowers' deteriorated financial condition and the effects of liberal underwriting conditions from 1996 to 1998, when speculative-grade originations were more common. For example, the 1999 and 2000 refunding risk studies conducted by Moody's noted that 16 percent and 17 percent, respectively, of all rated bank loans maturing in 2002 were rated B1 or lower. The trend worsened significantly in 2001, when the study noted that 39 percent of bank loans maturing in 2002 were rated B1 or lower. When firms have to refinance low-grade debts in today's environment, they may face additional pressure on earnings and liquidity.

Loss Severity Has Increased with Higher Default Rates

Moody's credit ratings reflect the likelihood of default and the severity of loss given default. As a result, the migration of maturing bonds and loans into lower grades implies a greater risk of default or increased loss severity upon default, or perhaps both. Moody's notes, as part of its 15th annual study of global corporate defaults and ratings performance, that average recovery rates fell for the third straight year in 2001.¹² The recovery rate has deteriorated for all levels of security and

CHART 6



¹² David Hamilton, et al., "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970–2001," *Global Credit Research*, Moody's Investors Service, February 2002. The recovery rate is defined as the secondary market price of the defaulted instrument approximately one month after the time of default.

TABLE 1

AVERAGE SPECULATIVE-GRADE RECOVERY RATES IN 2001 SHOW A DECLINING TREND IN NEARLY ALL LEVELS OF SECURITY AND SUBORDINATION		
SENIORITY/SECURITY	AVERAGE RECOVERY PER \$100	
	1982–2000	2001
SENIOR SECURED BANK LOAN	\$67.06	\$54.68
EQUIPMENT TRUST	\$64.65	NA
SENIOR SECURED BONDS	\$52.09	\$58.00
SENIOR UNSECURED BONDS	\$43.82	\$36.20
SENIOR SUBORDINATED BONDS	\$34.59	\$19.90
SUBORDINATED BONDS	\$31.83	\$16.45
JUNIOR SUBORDINATED BONDS	\$22.48	NA

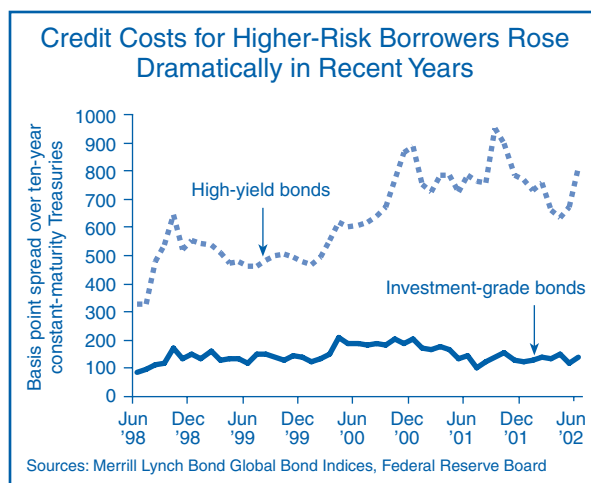
NOTE: NA=NOT AVAILABLE
SOURCE: MOODY'S

subordination except for senior secured bonds (see Table 1).

Higher-Risk Borrowers Pay High Premiums

A speculative-grade company refinancing debt today will face a much higher price, in terms of spreads over a cost of funds index or risk-free instruments, compared to several years ago. Yield spreads between investment-grade and speculative-grade bonds have widened significantly since early 2000 (see Chart 7), in part because of lower investor tolerance for risk, rising

CHART 7



defaults, and weakening corporate cash flows. After narrowing a bit in first quarter 2002, spreads have widened again on renewed concerns about accounting irregularities and the realization that the economic recovery may come at a slower pace than anticipated. Lower investor tolerance for risk has affected not only speculative-grade borrowers but also some investment-grade borrowers. For example, the commercial paper (CP) market, which many investment-grade borrowers have used as a cheap source of funding, is no longer readily available to all investment-grade borrowers.¹³

Drawn-Down Commercial Paper Back-up Lines Heighten Commercial Bank Exposure¹⁴

Since its peak at the end of 2000, the CP market for domestic nonfinancial companies has shrunk by almost 50 percent (see Chart 8). A reduction in the need for working capital and heavy refinancing activity have contributed to this contraction. However, the record number of downgrades among issuers of CP in 2001 also contributed to this decline. Money market funds cannot hold more than 5 percent of assets in CP graded less than A1/P1/F1.¹⁵ Thus, the recent flux of downgrades effectively squeezed some issuers out of this market and forced them to refinance with fixed-rate bonds.¹⁶ Also, fears of deteriorating credit quality have shut some investment-grade companies out of the CP market. Since the collapse of Enron, investors have been reluctant to hold the debt of certain companies. Some of these companies reported accounting irregularities, and the restatement of financial statements revealed previously hidden losses. In some cases, issuers that were not involved with accounting irregularities were forced to draw on bank credit lines when they were unable to roll over their CP because of the lack of demand or extreme-

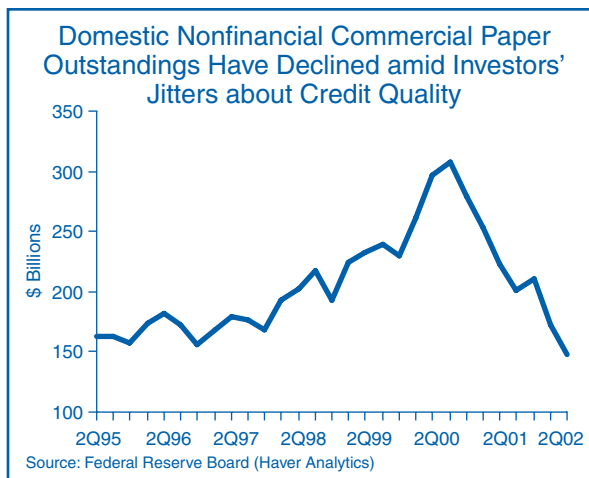
¹³ Commercial paper is short-term promissory notes issued by large firms, generally maturing in nine months or less. It is an important source of short-term funding for corporations that need a steady stream of working capital.

¹⁴ A CP back-up line is a commitment to provide a liquidity support for a company's CP program. It is typically a revolving credit, a 364-day facility. The rationale is that the borrower does not intend to use the back-up line, which generally costs more than issuing CP, unless the CP cannot be rolled over or repaid.

¹⁵ The CP market can be divided into three tiers: Tier 1 (A1/P1/F1 or better), Tier 2 (A2/P2/F2), and Tier 3 (A3/P3/F3). The first two groups make up the bulk of the market. The first rating refers to a rating assigned by Standard & Poor's, while the second and third reflect ratings assigned by Moody's and Fitch, respectively.

¹⁶ Moody's Investors Service, *Moody's Credit Perspectives*, December 31, 2001. Moody's downgraded 38 commercial paper programs from P1 in 2001.

CHART 8



ly high rates demanded by investors. When a CP issuer draws down on the back-up line, rating agencies often view this as a weakness in the company's liquidity, and a rating downgrade can occur. In turn, lower ratings lead to higher funding costs for the borrowers.

The steepness of the current yield curve also results in significantly higher refinancing costs for investment-grade corporations that no longer have access to short-term funding through the CP market. As these companies are forced to borrow longer term, they face higher refinancing costs in the long-term end of the current yield curve.¹⁷ For example, if a Tier 1 corporation formerly issuing 90-day CP was forced to issue ten-year fixed-term debt in mid-July 2002, the cost would have been almost 350 basis points higher than issuing 90-day CP.

Using back-up lines of credit when companies cannot roll over maturing CP has become expensive for some issuers. Bankers are realizing that initial pricing does not reflect the risk inherent in drawn-down lines. As a result, bankers have started to impose high utilization premiums on BBB-rated CP back-up lines. Also, borrowers recently have been seeking term-out options, another sign that refunding risk is a concern.¹⁸ Recent transactions reported by *Loan Pricing Corporation* show that some investment-grade companies are seek-

¹⁷Bloomberg Fair Market Sector Curves, July 5, 2002. The spread between 60-day and five-year Treasury instruments was nearly 300 basis points.

¹⁸ Once the back-up line has been drawn down, the borrower again has to repay or roll over the debt. A revolving facility can be "termed out" so that it becomes an installment loan with a much longer maturity, such as three to five years. Such an option, however, can be costly.

ing term-out options even at a fee of 200 basis points. The higher premiums demanded reflect both the volatility in the market and deteriorating credit quality indicated by high default rates and rating downgrades in recent quarters.

Conclusion

During the boom times of the late 1990s, corporations enjoyed an abundance of liquidity sources and easy access to capital. Many corporations used debt to finance business expansions, and rolling over maturing debt was not a significant concern. Recently, however, stock prices have been declining and investors have been concerned about the possibility of more corporate financial restatements. In this environment, highly

leveraged borrowers worry about maturing debts and refunding risk implications. Lenders are demanding higher spreads because of the volatile financial markets and the deteriorated financial condition and debt ratings of many borrowers. In general, firms seeking to roll over maturing debt clearly face a less hospitable financing market today. With corporate profitability not yet strong, highly leveraged companies may find it increasingly difficult to meet debt service requirements and loan covenants. Despite these hurdles, the economy appears to be improving, and more companies are beginning to report higher earnings. With an economic recovery and tighter underwriting standards, the deterioration in commercial credit quality should stabilize and turn around.

Cecilia Lee Barry, Senior Financial Analyst

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